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An Economic View

Higher Oil Taxes Justified

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Intermittent pressures on the dollar since the October 1978 exchange rate crisis indicate that further such crises are to be expected in 1979. The administration's reaction to the October crisis did not directly confront its cause, the American economy's dependence on oil.

This dependency means that a high trade deficit occurs whenever the United States is reasonably prosperous; oil dependency sets a cap on attainable prosperity.

The October crisis signaled that the financial world's capacity to absorb dollars created by United States trade deficits had been reached. Such crises will occur until the country's demand for oil at a full employment income is decreased or the United States, and with it the world economy, sinks into a deep and persistent recession.

The rise in interest rates since October is the only policy induced reaction to the exchange crisis that has any potential impact on the trade deficit. Higher interest rates can decrease a trade deficit only as they lead to a recession.

However, the American economy shows no signs of going into a slump in the near future. Continued prosperity virtually guarantees that there will be further exchange rates crises.

The 1930s experience indicates that a succession of financial crises, one soon after another, is part of the process by which the world economy goes into a deep and prolonged depression. The current course of American policy seems designed to assure that just such a process of successive crises takes place. To break this pattern, the United States full employment trade deficit must be eliminated. Realistically this means that taxes must be used to raise the price of oil products well above those implied by OPEC prices.

Before the political turmoil in Iran, the world supply of oil was on the verge of exceeding demand. Effective policy that reduced U.S. oil demand would assure that supply exceeds demand at the OPEC price soon after Iranian production resumes. OPEC has been successful because Saudi Arabia has been able to adjust its output so that the cartel's price is maintained. However Saudi Arabia's payment commitments are now so large that it cannot long sustain the cut in its income that would be required to maintain the OPEC price if taxes or a slump reduce American demand.

Marketing Quotas

Once Saudi Arabia cannot enforce the cartel's price, OPEC will have to set marketing quotas. The history of cartels shows that they break when they need to set restrictive quotas. A reduction in U.S. demand, whether due to taxes or a slump, will lead to turmoil within OPEC. A decline in the income of the oil states, a fall in the value of assets that have been bid up by the prosperity of the oil states, and a fall in the export earnings of countries that have benefited most from the prosperity of the oil states will follow.

Financial institutions based on the newly rich oil countries have emerged since 1973. The international banks have substantial assets whose value depends upon the continuation of the OPEC mandated oil prices. A financial shakeout, even a full-fledged financial crisis, will be triggered when the demand for oil falls.

Financial turbulence and a reduction of U.S. oil consumption will take place whether or not the United States takes positive steps to decrease demand. If the United States continues its present passive policies, demand will be reduced because increasingly disruptive financial traumas will lead to a recession. If taxes reduce oil demand, then the decline of OPEC's power will induce financial disturbances. In either case the near future will not be tranquil.

Not Equally Dismal

Although both scenarios promise turbulence, the prospects they hold are not equally dismal. The crisis and depression route leaves the United States with a weak banking system and no fiscal independence; such an economy cannot act as a locomotive for recovery.

Even though the demand constraint through taxes route will lead to financial disturbances, the United States will emerge with an intact banking system and fiscal independence. Such an economy can take the initiative in promoting an economic expansion.

The prospects for recovery are substantially better if the United States can be an active expansionary force than if the United States is constrained to being passive. A positive trade policy is preferable to the current passive stance.

If the United States raises taxes to cut demand, the taxes must be retained after the OPEC cartel breaks and the price of oil falls lest the cartel be given a new life. If U.S. demand is cut by a recession, then taxes on oil will have to be levied to establish fiscal elbow room before an expansionary policy can be adopted. It is perhaps a paradox, but only by being frugal can the United States again be affluent.